

Farm Finance



Farm Credit Use Expected To Rise Slightly

Total farm business debt will rise just 1.2 percent to \$182.8 billion in 2001, the smallest projected increase since debt dipped slightly in 1992. With limited potential gains in farm prices this year following the relatively low levels in 2000, farmers remain cautious about debt expansion. Also, the sector has evidently learned from the farm financial crisis of the 1980s that borrowing cannot substitute for adequate cash flow and profits.

Slow debt growth partially reflects moderate levels of expected new capital investments. In addition, adequate levels of working capital and off-farm earnings are helping farmers hold down new borrowing.

High levels of direct government payments to farmers (including emergency assistance) are also limiting demand for credit and helping to maintain farmland values. Farmers received an annual average of \$17.3 billion per year in direct payments for 1998-2001, up from \$8.8 billion for the 1990-97 period. Farmers have been maintaining or improving their balance sheets by applying some of their additional government payments to existing debt.

Nevertheless, continued low prices for many key agricultural commodities, coupled with weather problems in some regions, have generated concerns about the ability of farmers to repay new or existing loans. Many of the concerns focus on producers' ability to obtain and retain production credit. Net cash farm income, which measures cash available from sales after paying cash operating costs, declined from an annual average of \$58.1 billion in the favorable years of 1996-97 to \$55.5 billion in 1999-2000, even with sizable government assistance. Without additional emergency farm payments this year, farm lenders will be dealing with a farm sector whose net cash income is forecast to decline 10 percent to \$50.7 billion.

Although farm sector equity by the end of the year will be almost \$9 billion more than in 2000, a higher proportion of debt service capacity will be used, reducing farmers' credit reserves and exposing a larger share of farms to potential debt repayment problems. Farmers' use of net repayment capacity (debt held by farms as a share of the maximum feasible debt that farms can take on) is forecast to rise to 65 percent in 2001 (the highest level since 1985), compared with just under 60 percent in 2000. About 24 percent of farm

businesses with annual gross sales of \$50,000 or more are forecast to have debt repayment problems in 2001, up from about 21 percent the previous year.

Demand for Credit Is Moderate

The four traditional categories of institutional farm lenders are *commercial banks*, the *Farm Credit System* or FCS (a collection of federally chartered borrower-owned credit cooperatives that lend primarily to agriculture), *USDA's Farm Service Agency* or FSA (the government "farm lender of last resort"), and *life insurance companies*. Together these four classes of lenders accounted for 78.1 percent of all farm loans outstanding in 2000. The remaining share of farm credit comes from individuals and from nontraditional lenders, primarily input and machinery suppliers, cooperatives, and processors.

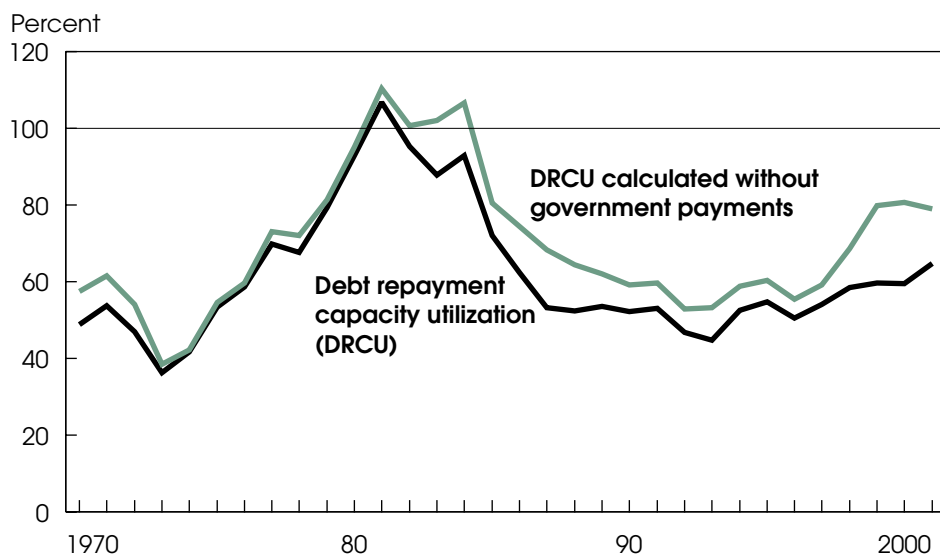
In calendar 2000, total farm business debt edged up 2.4 percent, and outstanding loan volume increased for all farm lenders except FSA. Commercial banks, with the largest share and fastest growth in loan volume, accounted for more than half the growth in total debt last year. Loan volume at commercial banks grew 3.3 percent to \$74.2 billion, followed by FCS at 3 percent to \$47.6 billion, and life insurance companies at 2.8 percent to \$11.8 billion. FSA's total direct loans outstanding decreased 5.8 percent in calendar 2000 to \$7.4 billion. The decrease resulted because large Federal program payments were substituted for credit needs and thus reduced the demand for FSA direct farm loans. At the same time FSA direct loan repayments continued at a significant rate.

The expected \$2.2-billion increase in total debt by the end of 2001 continues a prolonged expansion where farm debt rose \$5.2 billion per year, on average, between 1992 and 2000. About 40 percent of the overall increase in debt during this period occurred in 1997-98 when farmers were optimistic about business prospects following the planting flexibility provided under the 1996 Farm Act and relatively high commodity prices of 1996-97.

Farm real estate loan balances in 2001 are expected to rise slightly faster than

Farm Finance

Government Payments Have Helped Maintain Farms' Capacity To Carry Debt



2000 preliminary; 2001 forecast. DRCU=debt held by farms as a share of the maximum feasible debt that farms can take on.

Economic Research Service, USDA

nonreal estate debt, as they did last year, due partially to lender's requirement that loans for purposes other than mortgages be secured by farmland. In 2000, real estate and nonreal estate outstanding loan volume increased 3.3 and 1.3 percent, respectively.

Nonreal estate business loan volume outstanding is expected to increase about 1.2 percent to \$84.2 billion in 2001. Total planted acres for principal field crops in 2001 are forecast to decline, and even with some acreage shifts among crops, total production expenses are forecast to rise only modestly. Projections for planted acreage in 2001 for the eight major crops (corn, sorghum, barley, oats, wheat, rice, upland cotton, and soybeans) are for a decrease of 1 percent to 251.5 million acres. While farmers are expected to spend about \$201.7 billion for agricultural production expenses in 2001, up only 1 percent from 2000, there is concern about future oil and gas prices, which affect a variety of farm inputs. Expenditures for seeds, fertilizer, and agricultural chemicals, at \$26.7 billion, are forecast up slightly from 2000.

Unit sales of farm tractors, combines, and other farm machinery have not recovered from the 1998 malaise, when the farm

sector economic slowdown took effect. In 2000, sales of large two-wheel drive tractors (100 horsepower and over), four-wheel drive tractors, and combines were down 35, 49, and 45 percent, respectively, from their highs in 1997 (large two-wheel drive and four-wheel drive tractors) and 1998 (combines). For 2001, the Equipment Manufacturers Institute (EMI) projects a nearly 4-percent decline for two-wheel drive tractors, a 3-percent drop for four-wheel drive tractors, and a 7-percent decrease for self-propelled combines. EMI projects year-2000 increases for 12 of the 16 equipment categories other than tractors and combines, so optimism exists for sales of certain equipment lines.

On balance, sluggish sales for "big ticket items" such as tractors and combines are likely to overshadow sales strength for other machinery lines in 2001 and moderate demand for short- and intermediate-term loans. "Captive" finance companies owned by or subsidiary to machinery companies, rather than the more traditional institutional lenders, now meet a larger share of demand for big-ticket items.

Despite expected lower economywide interest rates in 2001 (see page 23), total farm sector interest expenses (excluding households) are forecast to grow from

\$13.8 billion in 2000 to \$14.3 billion in 2001. The anticipated 1.2-percent rise in total farm sector debt, accompanied by a lag in lowering of interest rates on the existing farm loan portfolio, will contribute to the rise in interest expenses.

Real estate loan volume outstanding—loans secured by farm real estate—is forecast to increase 1.3 percent to \$99 billion in 2001. Mortgage loan volume growth is generally affected by changes in farmland values. Total U.S. farmland values as reported in USDA's farm sector balance sheet rose an estimated 0.5 percent in 2000 and are expected to advance about 1 percent in 2001—the 15th consecutive annual increase. The outlook for 2001 is tempered by the scheduled reduction in government payments.

While recent farmland value growth rates are down, they have been buoyed by government payments, off-farm employment, and urban influences in many areas. It remains unclear if recent gains in farmland value have led to corresponding increases in demand for farm mortgage credit, even in the most favorable years. There are reports that a significant portion of the price gains were driven by nonfarm investors and not by farmers. Moreover, a good share of the farmer buyers were reportedly larger operators who were able to pay wholly or in large part with cash and not via borrowing. For midsize to smaller farms, off-farm earnings have been strong in recent years, allowing farmers to bid higher on farmland tracts than agricultural-use values would indicate. Today, wide areas are subject to urban pressures that tend to override the component of farmland value that is driven primarily by the land's value in agricultural use (AO April 2001).

Can Lenders Supply Adequate Credit?

Availability of funds is not a current concern since lenders have access to more money than they can profitably lend. As always, agricultural lenders will be looking closely at the profit margin of farmers' operations when making loan decisions. If borrowers cannot show repayment ability even with government assistance in 2001, chances are they will have

to curtail operations, restructure, or exit from farming.

The recent growth in farm loan demand experienced by *commercial banks* is reflected in higher loan-to-deposit ratios. Average loan-to-deposit ratios grew to 76.6 percent for agricultural banks in the year ending September 30, 2000, up from 73.5 percent a year earlier and from 57 percent 8 years earlier. Average loan-to-deposit ratios reported by the Federal Reserve System for agricultural banks increased during the year ending September 30, 2000, for all of the eight reporting Federal Reserve districts.

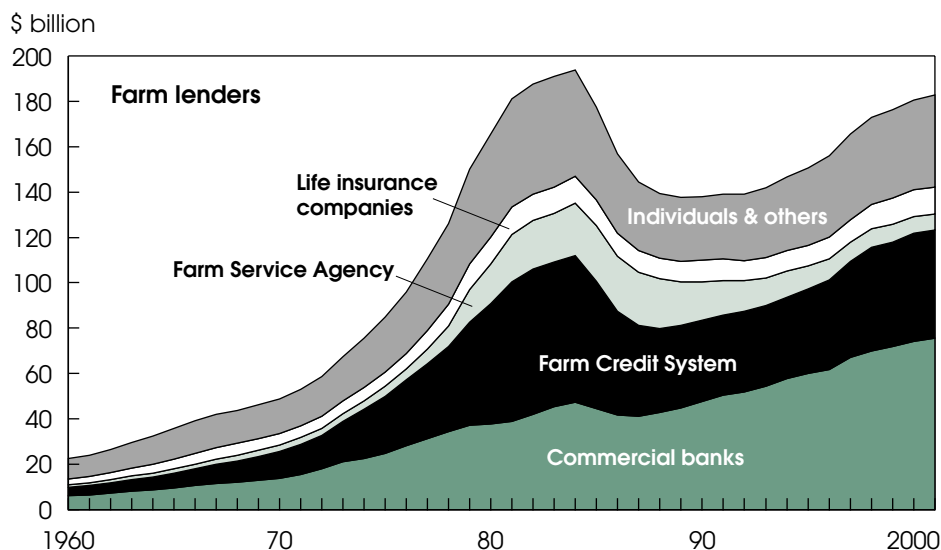
In the past, high loan-to-deposit ratios could constrain new loan origination. But today, commercial banks have many non-deposit sources of funds, such as the Federal Home Loan Bank System, and may sell farm mortgage loans to Farmer Mac. The recent jump in loan-to-deposit ratios may indicate larger reliance on these funding sources, plus sluggish growth in deposits. Thus, profitable, well-managed agricultural banks often have very high loan-to-deposit ratios. Although rural banks make considerably less use of non-deposit funds than banks headquartered in metro areas, most rural banking markets are served by banks that use nonlocal sources of funds to some extent.

Overall, adequate funds are available from banks for agricultural loans, with few banks reporting a shortage of loanable funds. Commercial bank total farm loans are projected to increase 1.8 percent in 2001, compared with 3.3 percent in 2000.

The *FCS* is in excellent financial condition and is thus well-positioned to supply farmers' credit needs in 2001. In recent years, the FCS has undergone massive restructuring of its organization and procedures. As a result, FCS gained farm loan market share 5 of the past 6 years after a gradual loss in 9 of the 10 previous years. Because of perceived government backing, the FCS can access national money markets and provide needed credit at very competitive rates.

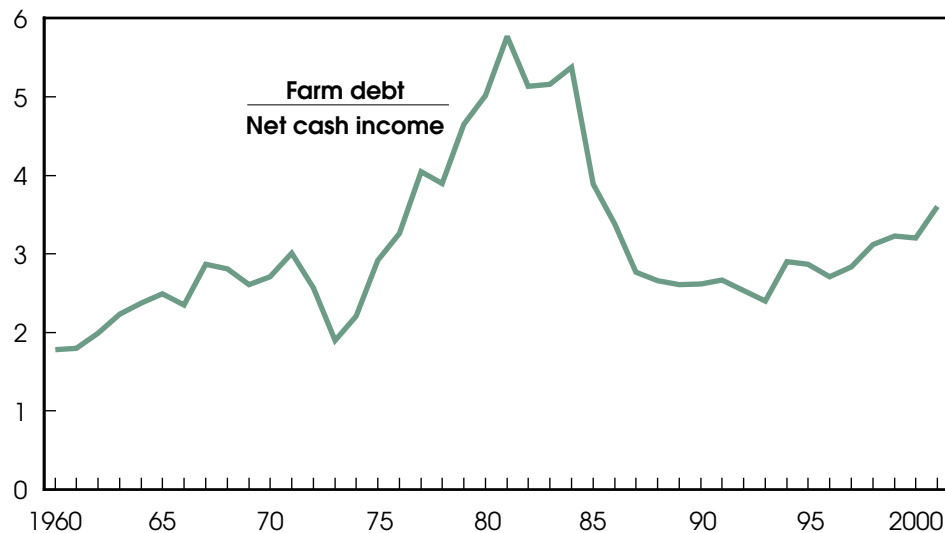
In 2001, FCS farm business debt is forecast to increase 0.2 percent following a 3-percent rise in 2000. FCS mortgage debt is expected to increase less than 1.2 per-

Total Farm Business Debt to Rise Slowly in 2001



Farm Debt Load Rose Above 3 Times Farmers' Net Cash Income in the Late 1990s

Ratio of debt to income



cent in 2001, and FCS nonreal estate loans are forecast to decline about 1.8 percent.

Farm Service Agency loans serve family-size farmers unable to obtain credit elsewhere. For fiscal 2001, FSA has \$4 billion in new lending authority. In fiscal

2000, FSA obligated \$3.7 billion in its direct and guaranteed farm loan programs. Through the first 6 months of the current fiscal year, it appears that the funding level will be sufficient to meet 2001 demand. The exception might be the direct farm ownership program that is restricted to funding farm mortgage loans

Farm Finance

and which has less lending authority for fiscal 2001 than was obligated in fiscal 2000. Another possible shortfall could occur for guaranteed operating loans made with interest rate assistance. Demand for the program is high because FSA provides a 4-percentage-point reduction in the borrower's loan interest rate. The 2001 appropriations bill gave FSA authority to transfer funds between the farm ownership and operating loan programs if funding shortfalls occur late in the year in a particular program.

Life insurance companies report adequate funds for the deals that meet their quality standards, and farm lending activity by life insurance companies is forecast up 2.4 percent in 2001 compared with 2.7 percent in 2000. During 1982-92, total industry farm mortgage holdings declined in 8 of the 11 years for an overall drop of 27.9 percent. Since then, holdings have increased each year for a total gain of 34.7 percent.

In the coming months, lenders will likely remain cautious in extending agricultural credit, due largely to uncertainty about farm commodity prices and the level of government payments. Lenders were able to manage most farm loan repayment problems last year, given the relatively

healthy recent farm incomes bolstered by the additional Federal financial assistance.

The 2001 farm financial situation is unlikely to lead to unmanageable deterioration in lenders' portfolios. But if the conditions that materialized in the agricultural sector starting in 1998 persist, lenders will increasingly face renewal requests for substandard loans and attract new customers that are less creditworthy, particularly if the level of Federal assistance packages declines. In this scenario, some farmers also would need to reconsider and reformulate their plans to use additional loans to finance operations. The year 2001 may prove to be more indicative than 2000 of the proper course of action for lenders and borrowers.

Today, despite relatively low prices, lenders appear confident about the bulk of their farm customers *given the level of Federal assistance*. Most farmers are not as heavily leveraged as a decade ago. Veteran lenders cite significant differences from the 1980s, including lower interest rates, more owner equity, better credit analysis and monitoring methods, and improved management ability of their producer-customers. Lenders thus will work with most of their customers to restructure debt and will continue to provide credit for operating expenses.

Some of the favorable prospects in farm lending likely stem from two hard-earned lessons from the 1980s: 1) credit cannot be used as a replacement for lost earnings, and 2) lenders must insist on earnings, not asset inflation, to assure repayment. The 1980s made it clear that farm businesses need to be profitable to successfully manage debt obligations.

The financial position of commercial agricultural lenders in 2001 is generally healthy. Farm lending institutions have been able to continue to build capital and maintain favorable credit quality levels in their loan portfolios. Lenders have benefited from improved management, higher loan standards, and better regulator oversight compared with the 1980s. All major lender categories continue to experience historically low levels of delinquencies, foreclosures, loan chargeoffs, and loan restructuring. Farm financial stress would not have a significant impact on aggregate national farm lender indicators such as loan delinquency rates unless the stress was sustained. The duration of relative price weakness for several major farm commodities is unclear, but the data indicate no significant problems in national lender performance to date. **AO**

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**For more information on the demand for farm credit
and the farm lender situation, see the latest issue of
*Agricultural Income and Finance***

at <http://www.ers.usda.gov/publications/so/view.asp?f=economics/ais-bb/>